Sunspur Global Fund

2017 Annual Letter

22 January 2018

Performance Overview

The 2017 return for Sunspur Global Fund[1], since inception in March 2017, is 18.6%, against the MSCI World Index ("MSCI") return of 17.4%, an outperformance of 1.2%. Since inception, our annualised return is 22.7%, against the MSCI of 21.2%, an outperformance of 1.5%.

Whilst we expect fund returns to continue to be meaningfully positive, our absolute performance this year is likely above our sustainable rate of return. This is due to generally high valuations in markets, our high cash position and the lack of easily available investment opportunities. Of course, if there is a substantial correction in markets or stocks, this could give rise to more opportunities – and the fund has sufficient dry powder to take advantage of such a situation.

Relative performance

In a strong year for equity markets generally, the fund's performance was substantially in line with the index. This is coincidental – as a long term oriented, absolute return fund, our strategy is not designed to mimic equity markets performance to any degree in the short to medium term, but is intended to outpace markets over the long term. Our decision to shy away from large index stocks should result in performance that diverges materially from the index. As such, there will be many months where fund returns are much higher or much lower than index returns. You can see this in our risk metrics, specifically through our low correlation and high alpha[2].

On technology stocks (or our lack thereof)

We believe that technology stocks are well within the circle of competence of this manager, having invested substantially in technology stocks before with satisfactory results. Yet why does the fund not own almost any technology stocks today? It is because we have better opportunities at cheaper valuations.

With technology stocks trading at 30-40x P/E, it seems less sensible to invest in them when we have credible alternatives trading at 5-10x P/E, even adjusting for growth. As an example, if I had $1.0m today, I can purchase a low-growth stock at 10x P/E that gives me a **certain** earnings stream of $100k. If I put $1.0m in the tech stock with comparable economics[3] at 30x P/E, its earnings would have to grow **25% per year for the next 5 years** before I receive the same earnings stream of $100k from the tech stock, and this outcome is far less certain than the $100k I will be receiving today. As the saying goes, a bird in the hand is worth more than the same bird in the bush five years from now.

In general, we do believe most of the highly popular technology stocks this year have amazing franchises – they are simply less likely, and less certain to deliver investment outcomes better than our alternatives, over time, at these prices.

Of course, we understand that human psychology and momentum can carry stocks far beyond where their share prices are today. Unfortunately, we have not mastered the art of 'buy high, sell

---

[1] Returns reference Class A NAV and is net of all fees and charges.

[2] Based on our December 2017 Fact Sheet, our alpha was ~ 63% and our R^2 was ~ 18%.

[3] By 'comparable economics' we mean similar franchise quality and sustainable returns on capital

higher' (a credible investment strategy if one can identify the required environment for this to succeed) and have elected to stick to our tested strategy of investing in quality assets at sensible prices. If investors feel inclined to participate in the broader market, we believe that many of the ETFs present better low-cost options compared to traditional active funds (but we do think Sunspur Global Fund will outperform both those alternatives over the long term).

Portfolio Contributors

The main positive contributors to the portfolio this year are Avis Budget Group and Baidu Inc. Both these positions contributed approximately 60% of this year's profits.

Avis Budget Group ("Avis")

Avis was the largest position in our portfolio in 2017 and the largest contributor to performance. Our initial investment in Avis was predicated on the sustainability of its strong free cash flows, its high free cash flow yield and the large amount of share buybacks being undertaken with those cashflows, against the backdrop of an attractive and improving 3-player industry structure, led by de-fleeting at Hertz. A detailed discussion on Avis was published in June 2017[4] and a copy is available on request.

Following our initial investment, much of the worries that led to the decline in Avis's share price dissipated, with industry fleet levels normalising over the summer, used car prices rising and hurricanes providing a temporary bump to expectations, resulting in a fair amount of long buying and short covering of the stock. This led to the share price moving from our average cost of ~ $24 to a range of $36-42 where we gradually sold out of the position for an average of $38, and redeployed the proceeds into other opportunities.

Baidu Inc. ("Baidu")

Baidu is China's largest Internet search engine, and makes money mainly by selling online advertising slots. Having had some trouble with unethical advertisers (specifically in healthcare), Baidu spent over a year combing through and cleaning up their advertiser base, which resulted in declining advertisers and stagnant topline growth over that period. This led to a de-rating of the shares, and rather gloomy forecasts of its economics going forward.

However, this also created an opportunity to acquire Baidu at a valuation of its core search business in the low-teens P/Es[5] and for the fund to make Baidu a Top 5 holding.

As Baidu cleared their 'advertiser cleanup', we gradually saw top line returning to growth and the shares re-rated. The share price moved from our average cost of ~ $180 up to levels where we sold the bulk of our holding at ~ $240. We still maintain a small position in Baidu.

Almost all other positions in the portfolio posted positive contributions of varying degrees.

Seritage Growth Properties ("Seritage")

The only significant loss position in the portfolio this year was Seritage Growth Properties, dragging profits by ~ negative 7%.

Seritage is a retail REIT spun out of Sears Holdings in 2015, with approximately 253 retail properties totalling over 40m sqft across the United States.

The decline in Seritage's share price seems to have been driven by the general mood towards retail in the United States, and to a lesser extent due to concerns about its main tenant, Sears

[4] See our document entitled "The Case of Avis Budget Group"

[5] Implied Baidu core search valuation is complex, as it has many non-search subsidiaries, only some of which are listed.

Holdings. We do believe the general view on retail is correct – physical retail is highly challenged, and mall tenants are facing significant headwinds from e-commerce.

However, the investment thesis is not predicated on retail doing well or otherwise, it is predicated on a low valuation relative to market rental rates, and current rentals that are **highly certain** to grow as the key tenant, Sears Holdings (which pays a substantially below-market rent) vacates space in their malls for redevelopment. It is relatively easy to see why:

Seritage Rental Income, as of Q3 2017

Tenant	% Annual Rent	Annual Rent (psf)
Sears Holdings	55%	4.44
Current 3rd Party Leases	21%	12.74
New 3rd Party Leases[6]	24%	17.85

Source: Seritage Growth Properties, as of Q317.

Most new leases have been, and continue to be signed at rents significantly above those paid by Sears – for every sqft that Sears vacates, Seritage can rent out the space to a new tenant at approximately **4x** the historical rent.

At the current share price of $40, Seritage is trading at approximately 16x FFO (a close proxy for cash earnings), at a discount to major retail mall REITs in the US. Not only is it undervalued relative to peers on current earnings, nothing is priced in for the significant growth in earnings they are likely to achieve, regardless of the state of retail in the US.

Furthermore, Seritage continues to deliver new lease signings and re-leasing of Sears space at a very healthy, and accelerating pace:

Seritage New Lease Signings by Quarter, as of Q4 2017

	Leased GLA (000 sqft)	Annual Rent ($ 000)	Annual Rent (psf)
Q1 2016	214	6,990	32.60
Q2 2016	422	7,240	17.15
Q3 2016	543	7,470	13.74
Q4 2016	891	14,900	16.72
Q1 2017	535	8,780	16.41
Q2 2017	598	11,340	18.95
Q3 2017	601	9,770	16.25
Q4 2017	870	14,790	17.00

Source: Seritage Growth Properties, as of Q417.

We have always viewed Seritage as a core, long term holding in the portfolio – whilst not expected to make a significant amount of money, it is expected to deliver satisfactory returns over time.

There were no other material loss making positions.

A note about Sears Holdings ("Sears")

Sears Holdings was a large position that saw material share price declines during the year, but the fund only realised a small loss overall on the position. This is due to the large amounts of short interest[7] received (short interest on Sears would fluctuate between 60%-100% p.a.), combined

[6] Signed but not yet operational leases.

[7] Short interest are payments short sellers make to us to borrow our shares, and this fluctuates daily with demand and supply for shorting of shares.

with some trading of the stock. Whilst not the core thesis behind our holding, receiving short interest was a good hedge against a potential price decline.

Our main thesis was that the continued 'right-sizing' of Sears would result in positive EBITDA, allowing them to slowly realise the value of their net assets[8] and that those net assets are worth substantially more than the share price. Whilst we continue to believe this is the case, the margin of safety has been eroded over time by continued cash burn and the slow pace of return to profitability.

As such, we have sold out of our equity position in Sears at a small loss, but still retain a position in their debt.

Portfolio Positioning and Outlook

In general, we feel quite comfortable about where the portfolio is currently positioned. All our top holdings remain slightly above cost[9], with no change to the investment thesis and with additional information and data points (such as ASP data, rental renewals and quarterly profits) continuing to reinforce our thesis for these stocks. As such, we believe there is sufficient upside to our holdings from current prices and expect them to perform well over time[10].

About our cash and cash-like position…

In some ways, 'cash' is our biggest overweight position. At the current level, the weighting of pure cash and cash-alternative securities which we hold (such as telcos) is the highest it has been in recent investing memory.

Implicit in our high cash level, is a certain wariness about pricing in markets and the lack of broadly available attractive investment opportunities. Given where equity valuations are today, and potential risks to inflation, interest rates and bond prices, we do not believe financial assets are likely to deliver more than single digit returns over the long term. To be clear, we do not believe that equity markets are overvalued relative to interest rates currently, simply that returns for most asset classes (at current prices) are likely to be low and to remain so for the foreseeable future.

Thus, our high cash position reflects what we view as the balance of risk in markets, the difficulty in finding new, attractive investments as well as dry powder reserve to facilitate any new discoveries or to take advantage of potential declines in stock prices. Of course, if opportunities do not present themselves and markets continue to grind higher, then cash which essentially earns 0% will remain a drag on the portfolio, as it was during 2017.

West China Cement ("WCC")

Our most attractive opportunity now lies in the shares of West China Cement. WCC is the largest integrated cement producer in Shaanxi province, China, which is also where China's One Belt One Road development initiative begins. We believe WCC shares present a highly attractive investment opportunity for the following reasons:

1. Significant and underappreciated structural change in cement supply

As part of broader initiatives around State-Owned Enterprise ("SOE") reform, China is seeking to structurally overhaul the supply of cement across China – to reduce existing overcapacity and to reduce the environmental impact from this energy intensive industry.

---

[8] Property, inventory, businesses and brands, net of pension and debt.

[9] As of this writing, most of our top stocks have had some positive moves since the year end.

[10] If we make an error in judgment, you can be sure to hear about it in our next annual letter.

Based on the 13th Five-Year Plan, State Council announcements and supplementary documents issued by industry bodies[11], China plans to reduce outstanding cement capacity, such that utilisation of cement plants nationally reaches 80% and the industry achieves a national profit margin of 8%[12] by 2020. This will be done by:

- Stopping all new capacity additions in cement
- Consolidation and removal of smaller, less efficient players – either through acquisition or the implementation of much stricter environmental standards
- Implementing plant closures and production cuts to smooth out peak production and reduce environmental impact
- Discontinuing the use of lower grade cement, leading to increased use of clinker content
- Coordinating[13] supply, production and pricing of cement as well as consolidation through the industry association

Most of these measures are well underway – there have been no approvals for any new cement capacity, smaller players are being acquired by cement majors and sub-scale production is now uneconomical due to environmental regulations - this has resulted in reduced supply, removal of marginal capacity, lower cement inventory and pricing of cement above 5-year highs.

The Chinese government has a real need, incentive and ability to keep these initiatives on track. Pollution has become a significant issue for the country (cement is energy intensive), and the country needs to restructure from infrastructure-led growth to an environmentally greener, more services and consumption oriented economy. With power in the Chinese leadership now consolidated and with large cement players all state-owned, China's central control system should allow for the smooth implementation of the initiatives above.

As such, we expect to see continued consolidation in the industry, continued supply cuts and a sustained non-competitive environment where all major cement producers are actively working together to ensure the health (i.e. profits) of the industry.

2. A highly attractive regional oligopoly

Cement is essentially a regional market - as there are geographical limits around how far cement can travel economically. Whilst clinker can be transported with relative ease, Chinese clinker production tends to be consumed in an integrated cement supply chain and not much pure clinker is sold. The risk of imported clinker to WCC is also limited, as Shaanxi is reasonably deep inland, and pricing is materially lower than the national average.

In Shaanxi, well over 80% of the capacity in the areas where WCC operates is controlled by 4 players (with WCC being the largest). Anhui Conch, as one of the big 4 players, also owns a stake in WCC – and they have both been operating very closely over the last few years. In addition, we expect demand growth to continue to be stable in Shaanxi, as it is a relatively underdeveloped province in China and is a key part of China's One Belt One Road initiative.

This industry structure, combined with continued demand growth makes for favourable competitive dynamics. In essence, cement in China is no longer a commodity industry, but is becoming a stable, profitable oligopoly – something greatly underappreciated by the market.

3. Improving cyclical and structural economics with significant operating leverage

[11] Document 34 (2016) of the Chinese State Council, Document 118 (2017) of the Chinese Cement Association.
[12] WCC's net profit margins should be above this figure at current prices, but there are many large, inefficient producers who will bring down the national average.
[13] Pricing and supply is now essentially determined collectively by the top cement producers in China.

After a period of capacity expansion, and a demand slowdown in China, cement pricing declined almost 30% from their peak in 2013. This has completely reversed today, with pricing at (or above) 5 year highs. As an industry with significant operating leverage (i.e. high fixed costs), most of the increase in cement pricing has flowed through to the bottom line, resulting in a significant increase in profitability. Given the industry environment we described above, we expect pricing, on average, to remain stable or higher than the levels achieved in 2017 and consequently, for profits and cashflows to remain sustainably high.

In addition, WCC has expanded into the mining for third party sale of aggregates, from quarries they already own or will acquire. They expect this to contribute materially to profitability and cashflow over the coming year[14] and we are awaiting financial results from this endeavour.

4. High and rising free cash flows yields

WCC is also extremely attractive due to its **high and rising** free cash flow ("FCF") yields. Our estimates for 2017 put WCC FCF yields at comfortably over 20% (or a cash P/E of < 5x), and this is expected to rise over the coming year even if cement prices simply remain stable at the levels coming out of 2017[15].

This gives us a tremendous margin of safety even if industry trends do not play out as we forsee – that being said, evidence to date suggests everything is on track and sustainable.

5. Poised for capital return, and potential M&A

With such strong free cash flows, we expect management to return a sizable portion of this to shareholders in the form of dividends (or buybacks). The aligned incentives of shareholders (the Chairman, with a ~ 30% stake and Anhui Conch, with a ~ 20% stake) suggest that simple cash return is far more likely than any other potential use or misuse of cash.

Finally, WCC is also a potential target to be acquired by a larger player (probably Anhui Conch), and this provides some degree of optionality to support the investment thesis.

In Closing

We thank you for your support over the last year, as we endeavour to continue producing satisfactory returns for you and hope to continue to grow our relationship well into the future.

If you have any queries, please do not hesitate to contact me at:
wenwei.loke@swissasia-group.com or +65 6715 9614.

Regards,

Loke Wen Wei
Portfolio Manager
Sunspur Global Fund

---

[14] Based on management guidance, this could add a significant double-digit % to free cash flows, with a short payback period on investment. We view this as an additional margin of safety, and will adjust our view as actual results come in.
[15] Real time pricing data suggests pricing is on a continued rise.